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An Empirical Analysis of the Role of Fraud in Client Firm Market Reaction to Auditor Lawsuits

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Extant research demonstrates that litigation against an audit firm negatively affects the market value of its publicly traded clients. This study investigates the role of fraud allegations in client firm reactions to the disclosure of auditor lawsuits. Results indicate that the market reacts more negatively to auditor lawsuit disclosures that involve fraud allegations than those that do not contain such allegations. The stronger negative reaction to lawsuits involving fraud occurred despite the presence of several other variables, including damage requests, audit firm structure, government-initiated litigation, and shifts in the auditor's legal environment. Although overall results are consistent with both the insurance hypothesis and audit quality argument, the findings pertaining to audit firm structure and lawsuit damages tend to be more supportive of the insurance hypothesis.

INTRODUCTION

The bankruptcy of Laventhol and Horwath (L&H) in November 1990 provided a unique opportunity to study the market reaction of client firms to the severest negative information concerning an audit firm. Baber, Kumar, and Verghese (1995) evaluated 75 clients of L&H and demonstrated that these clients earned a statistically significant risk-adjusted return of -1.91% during the two-day trading period surrounding the Laventhol and Horwath bankruptcy disclosure. In addition, Menon and Williams (1994) evaluated 100 L&H firms and found that these firms had mean returns approximately 2.5% lower than non-L&H client firms in the same period. Menon and Williams (1994) state that this significant negative return is due to the fact that Laventhol and Horwath was no longer available as a source of funding or "deep pocket" in the event the client became insolvent. This explanation is commonly known as the insurance hypothesis. Baber, Kumar and Verghese (1995) posit that the market reacted due to either the insurance hypothesis, or that the bankruptcy filing led investors to reevaluate the quality of the audit information provided by Laventhol and Horwath.

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